

ACCOUNTING FOR SALES AND PLEDGES OF RECEIVABLES

I. INTRODUCTION

This paper addresses the accounting and financial reporting requirements in transactions where a factoring client (“the client”) exchanges an interest in its expected cash flows from collecting specific existing receivables for immediate cash payments from the factor.

The financial reporting question addressed by this paper is whether these transactions should be:

- Regarded as a sale, and therefore revenue, or
- Regarded as a collateralized borrowing resulting in a liability.

This paper establishes criteria that the client must use to ascertain whether the proceeds received should be reported as revenue or as a liability. The criteria must be used to determine the extent to which the client either retains or relinquishes control over the receivables through its continuing involvement with those receivables. A transaction must be reported as a collateralized borrowing *unless* the criteria indicating that a sale has taken place are met.

In addition, this paper provides guidance for:

- Sales of existing receivables within the same financial reporting entity (for example, between a parent company and a subsidiary); and
- Recognizing other assets and liabilities arising from the sale of specific existing receivables including residual interests and recourse provisions.

In order to remain compliant with international accounting standards, the client is required to:

- Identify, evaluate and properly report existing and future transactions where future cash flows associated with specific existing receivables have been exchanged to determine whether the transaction should be reported as a true sale, or a collateralized borrowing; and
- Identify and evaluate existing and future transactions where sales of existing receivables or future revenues have occurred, or are being considered, among entities within the client’s financial reporting entity; and
- Ensure appropriate disclosure of future revenues that have been pledged or sold, including information as to which revenues will be unavailable for other purposes and for how long they will continue to be unavailable.

This paper outlines a possible approach to the application of international accounting standards to a client’s financial statements, assuming the client is in the position of obtaining proceeds from the sale of existing receivables, not from the position of buying receivables from another organization.

II. ASSESSMENT PROCESS RELATED TO A TRANSACTION INVOLVING THE SALE OF EXISTING RECEIVABLES

Assessing A Transaction Involving An Exchange Of The Client’s Interest In The Future Cash Flows Associated With A Specific Existing Receivable

An exchange of the client's interest in the future cash flows associated with a specific existing receivable should be recognized for financial reporting purposes as a collateralized borrowing rather than a sale *unless* the appropriate criteria are met.

The most significant factor distinguishing sales from borrowings is the continuing involvement of the client. Certain criteria must be met that demonstrate that the client is no longer actively involved with the specific existing receivables it has transferred to another party. A sample of the criteria, although not an exhaustive list, includes:

- Neither the client nor the factor can cancel the sale;
- The client cannot limit in any significant way the factor's ability to subsequently sell or pledge the receivables;
- The client no longer has access to the receivables, or the cash collected from them in any substantive manner; and/or
- The client cannot unilaterally substitute for or reacquire specific receivables without the factor's consent.

Accounting For Transactions That Meet The Criteria To Be Reported As Sales

If the criteria for sale reporting are met, the client should no longer recognize as assets the receivables sold, removing the individual accounts at their carrying values. The difference between the proceeds (exclusive of amounts that may be refundable) and the carrying value of the receivables sold should be recognized as a gain or loss in the period sold.

Accounting For Transactions That Do Not Qualify As Sales

If the criteria for sale reporting are not met, the transaction should be reported as a collateralized borrowing. The receivables should be considered for financial statements purposes as being pledged rather than sold. Proceeds received by the client should be reported as a liability, collateralized borrowing obligation, separated between the current and non-current portions, in the Statement of Net Assets and as "other non-capital financing activity" in the Statement of Cash Flows.

The pledged receivables should continue to be recognized as assets in the client's Statement of Net Assets. Collections of these receivables that are subsequently paid to the transferee are reported as "other non-capital financing use of cash" in the Statement of Cash Flows and reduce the collateralized borrowing obligation in the client's Statement of Net Assets. Any pledged receivables collected and paid to the transferee after the collateralized borrowing obligation has been liquidated should be reported as an operating expense in the Statement of Revenues, Expenses and Changes in Net Assets.

III. RECOGNIZING OTHER ASSETS OR LIABILITIES ARISING FROM A SALE OF SPECIFIC RECEIVABLES

Residual Interests

If the client acquires either a subordinate or junior note, or a residual certificate, both representing the right to collections that exceed a stipulated level, the client must recognize the note or certificate as an asset representing a residual interest in ***excess receivable collections***.

Consideration must be given to the likelihood of collection. Residual interests recognized in the period in which the sale occurred should be treated as an adjustment to the gain or loss. Residual interests recognized in subsequent periods, for example, as a result of subsequent realization

and collection, should be reported as revenues once the appropriate revenue recognition requirements have been met.

Because the timing of the recognition of residual interests is difficult to generalize, it should be discussed on a transaction by transaction basis as the situation arises.

Recourse And Other Obligations

The client should recognize estimated liabilities arising from the purchase and sale agreement when information available prior to the issuance of the financial statements indicates that it is probable that a liability has been incurred at the date of the financial statements *and* the amount of the liability can be estimated.

Examples are recourse obligations or repurchase commitments. Further guidance on the recognition of these types of potential liabilities can be found in **Financial Accounting Standards Board Statement No. 5: "Sales And Pledges Of Receivables And Future Revenues"**

IV. INTRA-ENTITY TRANSFERS OF ASSETS AND FUTURE REVENUES

These transactions are unusual for the typical small to middle-market client and should be discussed with the client if they arise.

If a transaction is being considered that involves the transfer of capital and financial assets within the same financial reporting entity – for example, between a client's parent company and its subsidiary or a subsidiary and the parent – the financial reporting treatment is not the same as if the same transaction occurred with an external entity.

In these situations, the transferee should recognize the assets at the carrying value of the transferor. For example, if the subsidiary sold receivables to the parent, the parent should recognize the receivables acquired at the carrying value of the subsidiary. If there is a difference between the amount paid by the parent (exclusive of amounts that may be refundable) and the carrying value of the receivables transferred, that difference should be reported as a gain or loss by the subsidiary in their separately audited financial statements and as an operating revenue or expense in the parent's statements. However, these amounts must be reclassified in the consolidated client statements as a non-operating subsidy.

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